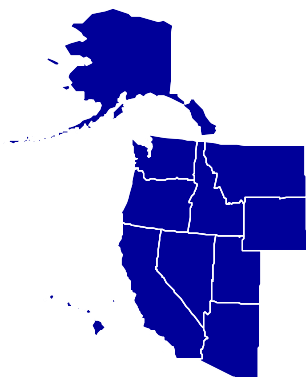

◆ Regional Outlook ◆

FEDERAL DEPOSIT INSURANCE CORPORATION

FIRST QUARTER 1997

In Focus This Quarter

FDIC SAN FRANCISCO REGION



■ ***Consumers Declare Bankruptcy in Record Numbers*** - Despite favorable economic conditions, consumers are declaring bankruptcy in record numbers in the San Francisco Region. The increases in both personal bankruptcy filings and consumer credit losses are part of a national trend which has the attention of industry participants, regulators, and Congress. *See page 3.*

■ ***New Tax Benefits for Owners of Community Banks*** - The Small Business Job Protection Act of 1996 allows closely held banks, thrifts and holding companies to take advantage of various pass-through benefits of the subchapter "S" corporation tax structure. These benefits are potentially substantial and may increase the inherent value of community banks. *See page 6.*

■ ***Savings Association Insurance Fund (SAIF) Capitalized*** - After more than two years of hard work by regulators, Congress, and the banking and thrift industries, the Deposit Insurance Funds Act of 1996 was passed to address the serious problems of the SAIF. *See page 9.*

DIVISION OF INSURANCE

CATHERINE I.
PHILLIPS-OLSEN,
SENIOR REGIONAL
ANALYST

GARY C. ZIMMERMAN,
REGIONAL ECONOMIST

Regular Features

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- Six Star States
- California Rebounds
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- WY & AK Lag Behind

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Dear Reader,

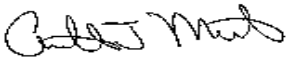
The prototype edition of the *Regional Outlook* for the San Francisco Region is attached. The *Regional Outlook* is produced by the Division of Insurance (DOI) and is designed to discuss events and trends affecting insured depository institutions in your region. This publication will be produced and distributed quarterly in our effort to share information and work with the Divisions of Supervision (DOS) and Compliance and Consumer Affairs (DCA) to identify emerging risks to insured depository institutions.

The publication contains two sections. The first section, *In Focus This Quarter*, contains several articles which are designed to address significant issues affecting insured depository institutions. The articles are not intended to represent an exhaustive coverage of the subject matter or to be examination guidance. The second section, *Regular Features*, will focus on the Regional Economy, Financial and Commodity Markets, and Banking. This section is not intended to be a substitute for your local or national newspaper but is intended to address some emerging trends and relate them to insured depository institutions.

This publication is regional in focus with individual states and metropolitan areas highlighted where possible. We recognize the importance of local economic information to examiners and intend to address that particular need more thoroughly in another product. DOI will provide periodic economic analyses at the Field Office level in the future.

This publication may be distributed on a wider basis in the future, but it was designed largely with an examiner audience in mind. DOI is very appreciative of the time and constructive feedback members of DOS's and DCA's Chicago staffs provided in the design and testing of the *Regional Outlook*. Many of the suggestions received from those individuals were incorporated into this publication. Your comments on the publication's format and contents, including suggestions for future articles, are welcomed. We also would appreciate your thoughts about the desirability of providing this publication by way of our intra-net homepage, or some other electronic format.

Sincerely,



Arthur J. Murton
Director

The *Regional Outlook* is published quarterly by the Division of Insurance of the Federal Deposit Insurance Corporation, 550 17th Street N.W., Washington, D.C. 20429. Visit the Division of Insurance online at <http://fdic01/division/doi/>. For more information on this publication, please call Catherine I. Phillips-Olsen at (415) 974-4247 or email her at [Catherine I. Phillips-Olsen@DOI@San Francisco](mailto:Catherine.I.Phillips-Olsen@DOI@San Francisco).

The views expressed in the *Regional Outlook* are those of the authors and do not necessarily reflect official positions of the Federal Deposit Insurance Corporation. Some of the information used in the preparation of this publication was obtained from publicly available sources and is considered reliable. However, its use does not constitute an endorsement of its accuracy by the Federal Deposit Insurance Corporation.

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Arthur J. Murton, Director, Division of Insurance

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PROTOTYPE

Consumers Declare Bankruptcy in Record Numbers

Trend Raises Concerns about Consumer Credit

- **Despite favorable economic conditions, personal bankruptcy rates are rising throughout the San Francisco Region.**
- **Three states in the San Francisco Region, Nevada, California, and Oregon, are among the ten states with the highest per capita bankruptcy rates in the country.**
- **Credit card charge-offs are approaching recession levels.**

Despite favorable economic conditions, consumers are declaring bankruptcy in record numbers in the San Francisco Region. The increases in both personal bankruptcy filings and consumer credit losses are part of a national trend which has the attention of industry participants, regulators, and Congress. Both the Senate and House Banking Committees have held hearings on the condition of consumer credit, particularly credit card lending. Much of the concern regarding these trends is due to the fact that bankruptcy filings and charge-offs are rising despite low unemployment and rising income levels.

What Is Occurring in the San Francisco Region?

Chart 1 shows the rising trend in consumer loan losses in the San Francisco Region as well as the close relationship between these losses and personal bankruptcy

filings. In states such as Utah, Arizona, and Nevada, where large credit card banks are located, there is less correlation because the loan portfolios are more geographically diverse.

Table 1 (next page) shows that personal bankruptcy rates are rising in all states throughout the Region. Current levels are high when compared to other states in the U.S., with six states in the Region exceeding the average per capita filing rate for the nation. Nevada topped the Region's list despite its lower than average ratio of debt to disposable income. Alaska continues to have a very low rate despite high unemployment. A recent study by **SMR Research Corporation** suggests that Alaska is a special case because physical access to a bankruptcy court is difficult for many due to distance.

Why Are Consumer Credit Losses Rising in an Expanding Economy?

The emergence of consumer credit problems during an expanding economy is not unprecedented. During the last economic expansion, consumer delinquency and charge-off rates also rose. Consumer debt tends to rise when employment rises because households are more willing to incur debt and banks are more willing to lend. Chart 2 shows that past cycles of rising growth in consumer credit have been followed by rising delinquency rates, even during periods of expansion.

CHART 1

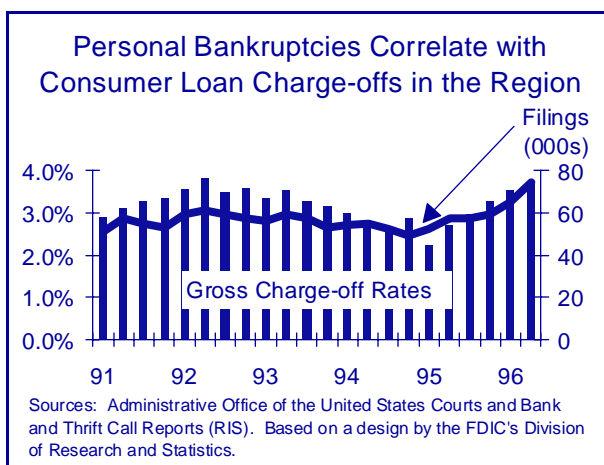
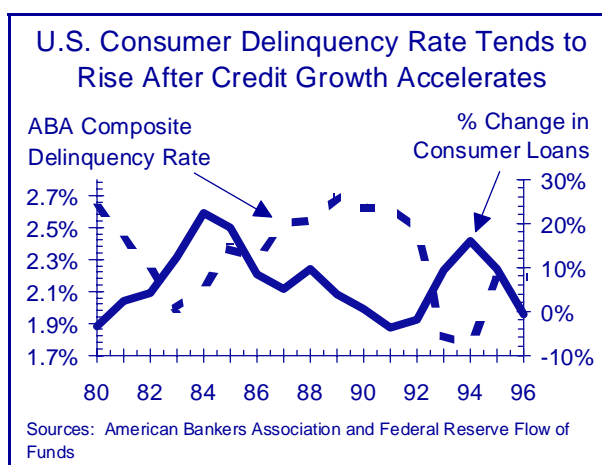


CHART 2



As the expansion closes out its sixth year, American consumers are holding historically high levels of consumer debt -- the ratio of total consumer debt service payments, including mortgage, to disposable personal income is approaching record highs and is currently at 17 percent. High debt levels appear to be the result of several years of economic expansion along with credit card companies' intensive efforts to generate and feed consumers' appetite for credit. Consumers and their lenders are now experiencing the after-effects of this credit expansion. California and Hawaii have the highest levels of debt to disposable income in the region. However, SMR attributes Hawaii's debt level to high housing costs.

Why Are Bankruptcy Rates Rising?

Nonbusiness bankruptcy filings for 1996 will exceed one million for the first time in U.S. history. This level is 11 percent higher than the peak in the last recession and a 14 percent increase over 1995 filings. A variety of theories have been advanced to explain this trend. These theories include:

- Consumers have overextended themselves.
- Recent changes in bankruptcy laws make it easier to shield assets from creditors.
- Changes in legal practices promote bankruptcy.
- The social and financial repercussions associated with bankruptcy have diminished.

In fact, the trend is likely the result of several factors,

many of which are interrelated.

SMR's study attributes differences in filing rates more to state regulations than to economic conditions. The study found that bankruptcy is driven by the number of and exposure to catastrophic events. Specifically, in four states in the Region with the highest bankruptcy filings per capita, California, Nevada, Washington, and Oregon, SMR attributes a high filing rate to a high divorce rate. SMR also attributes Oregon's and Washington's high filing rate to a high self-employment rate. Small business failures often lead owners to declare personal bankruptcy. The report identifies other factors driving up bankruptcy rates such as:

- inadequate health insurance;
- inadequate auto insurance;
- garnishment of wages; and,
- high debt-to-income ratios.

All of these conditions increase consumers' exposure to catastrophic events, such as job loss, that are typically associated with personal bankruptcy.

Of interest to lenders is that some traditional early warning signs of trouble -- such as erratic missed payments or paying off a smaller share of outstanding balances -- are not evident this time. *Some banks are finding that obligations due to them are being wiped out in bankruptcy court on accounts that showed no prior problems.*

Implications for Insured Institutions

TABLE 1

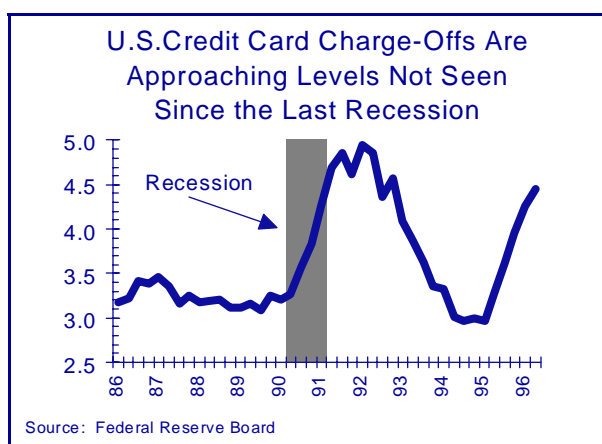
BANKRUPTCY RATES PER THOUSAND PERSONS							
	1991	1992	1993	1994	1995	3RD QTR 1996 ANNUAL.	3RD Q 96 STATE RANKING
ALASKA	0.22	0.20	0.18	0.17	0.19	1.59	50
ARIZONA	4.75	4.72	4.05	3.52	3.55	4.28	17
CALIFORNIA	4.17	4.78	4.58	4.17	4.27	5.31	6
HAWAII	0.90	1.10	1.12	1.22	1.58	2.27	47
IDAHO	3.80	3.37	2.95	2.67	3.21	4.12	19
MONTANA	2.36	2.16	2.00	2.02	2.44	2.92	37
NEVADA	5.28	5.63	5.36	4.64	4.78	6.13	4
OREGON	4.46	4.33	3.95	3.83	4.24	4.94	9
UTAH	4.20	4.22	3.52	3.34	3.63	4.36	16
WASHINGTON	3.20	3.36	3.03	3.08	3.65	4.88	11
WYOMING	3.09	2.58	2.33	2.26	2.35	3.46	27
UNITED STATES	3.46	3.52	3.15	3.00	3.33	4.15	NA
SOURCE: BANKRUPTCIES - ADMINISTRATIVE OFFICE OF THE UNITED STATES COURTS POPULATION - CENSUS BUREAU							

These trends have raised concerns about the outlook for credit card lenders. As shown in Chart 3, credit card charge-offs are approaching levels not seen since the aftermath of the 1990-1991 recession. During that recession, charge-off rates increased sharply. The question arises whether there would be a similar sharp increase in credit card losses during a future recession, driving credit card loss rates to levels well above their previous peak.

This concern is heightened by a number of factors. Consumer debt burdens are at historic highs. Profit margins for the nation's specialty credit card lenders (institutions whose total loans exceed 50 percent of managed assets and whose credit card loans exceed 50 percent of total loans) have rapidly narrowed from a 4.25 percent quarterly return on assets (ROA) in the third quarter of 1994 to a 2.02 percent quarterly ROA in the third quarter of this year. Competitive pressures on pricing and underwriting remain intense, as some companies continue aggressive card solicitations, and there are few signs of any slackening of price competition. A sharp rate cut for AT&T credit cards, one of the largest credit card lenders, is a recent salvo in this price competition. *Lenders also place great reliance on credit scoring models that have not yet been tested in a recession* and, according to a recent Federal Reserve survey, appear overly optimistic in almost two-thirds of the banks surveyed.

Other factors mitigate these concerns to some extent. Pricing of credit card loans has traditionally built in a margin of comfort for high and volatile losses. Loan portfolios are diversified with many small loans to individuals. There are preliminary indications that lenders and borrowers are retrenching to some extent. Consumer credit growth slowed from over 14 percent in both 1994 and 1995 to an annualized rate of 8 percent (seasonally adjusted) for the first ten months of 1996. In

CHART 3



the Federal Reserve survey just mentioned two-thirds of banks reported raising the score an applicant must achieve to qualify for credit, and one-third reduced credit limits for existing customers.

Generalizations about the outlook for credit card lending are difficult. Trends that describe the industry on average may not hold true for particular institutions. Performance is likely to vary substantially, with results depending on the risk management practices and underwriting standards of each institution. Given the trends outlined above, credit card lending practices appear worthy of continued close attention by bankers and regulatory agencies.

*Diane Ellis, Senior Financial Analyst
Maj-Brit Melugin, Division of Resolutions
and Receiverships*

New Tax Benefits for Owners of Community Banks

Subchapter "S" Benefits Now Available

- Potential benefits are substantial. A layer of tax expense has been eliminated.
- Eligibility is restricted and requires care to maintain.
- While no application to the banking agencies is required, the new tax structure has supervisory implications.
- The new tax structure has some potential drawbacks.

Eligibility Is Restricted

The new law allows, for the first time, financial institutions including banks, thrifts, and holding companies to elect subchapter "S" status if they meet several criteria. *The most important of these requirements are that the company not use the reserve method of accounting for bad debts for tax purposes and that it have 75 or fewer eligible shareholders.* All shareholders must consent to the subchapter "S" election and the IRS must consent to any change in the tax accounting for bad debts. To be able to receive the benefits for tax year 1997, institutions therefore may need to act quickly since changes in either of the above areas may be time consuming.

Introduction

The Small Business Job Protection Act of 1996 allows closely held banks, thrifts and holding companies to take advantage of various pass-through benefits of the subchapter "S" corporation tax structure. These benefits are potentially substantial and may increase the inherent value of community banks.

Reserve accounting for bad debts for tax purposes is an issue affecting only smaller institutions. Currently, reserve accounting is allowed only for those thrifts and banks under \$500 million in assets that are not part of a group with more than \$500 million in assets. To elect the new tax status, the subchapter "S" company will need to make the accounting change to the specific charge-off method for tax purposes. Presumably, the

TABLE 1

NUMBER OF BANKS IN THE REGION WITH UNDER \$100 MILLION IN TOTAL ASSETS			
	NATIONAL	NON-MEMBER	STATE MEMBER
ALASKA	1	0	0
ARIZONA	3	8	4
CALIFORNIA	56	96	15
HAWAII	0	6	0
IDAHO	0	6	1
MONTANA	18	37	33
NEVADA	2	9	2
OREGON	1	15	6
UTAH	3	20	5
WASHINGTON	15	40	0
WYOMING	12	7	21
TOTAL	111	244	87
SOURCE: PRELIMINARY BANK CALL REPORTS AS OF 9-30-96			

IRS will not object to any such change, which can delay deductions and increase taxable income, and will allow the change to be effective as of the beginning of the tax year.

In relation to shareholder eligibility, ownership of subchapter "S" corporations is limited to individuals, estates, and a few types of trusts. At present, certain shareholders, such as corporations, Employee Stock Ownership Plans (ESOPs) and other stock bonus plans, may not hold shares in subchapter "S" corporations. Once the subchapter "S" election is taken, the corporation and its shareholders must take care to continue to meet all eligibility requirements or risk losing the tax benefits.

Industry observers have suggested that over 1,000 banks nationwide will make the subchapter "S" election.

Number of Eligible Institutions

While exact figures on the number of eligible institutions are not available, the number of small banks may provide insight into where the tax election may be seen. As Table 1 (next page) shows, there are about 442 commercial banks in FDIC's San Francisco Region with under \$100 million in assets. It is expected that a large percentage of these companies would meet the eligibility requirements. Industry observers have suggested that over 1,000 banks nationwide will make the subchapter "S" election.

Benefits to Shareholders

The tax benefits of the "S" corporation are similar to those of a partnership. The earnings of the corporation generally are not taxed at the corporate level but pass directly to shareholders' personal income. *As such, cash distributions to shareholders are not subject to an additional layer of taxation, which results in a reduction in overall taxes.* Shareholders remain liable for personal taxes on their proportionate share of the corporation's taxable income. Distributions formerly paid directly to the IRS by the institution generally would be made to the shareholders, providing them with the funds to pay income taxes on their share of the corporate income. An interagency letter, FIL-91-96 dated October 29, 1996, notes that these distributions will be treated as dividends by the regulatory agencies. Adding value and flexibility to the "S" corporation structure is the ability to wholly own other "S" corporations. These rules allow holding

companies and their bank or savings association subsidiaries to be "S" corporations.

Other Tax Liabilities

For bank or thrift companies that elect to convert to "S" corporation status, there are potentially some other corporate tax liabilities for unrealized gains accumulated through the date of conversion. As an example, should the fair market value of all company assets exceed the adjusted tax bases of these assets, there may be some corporate tax liability if any assets are later sold. Assets held on conversion date and sold within the next ten years require a calculation for "Built-in Gains Tax" (BIG tax) to determine any tax at the corporate level.

Supervisory Implications

While an application to bank regulators is not required for this tax election, there may be a rise in various "phantom bank mergers" or change-in-control applications as companies work to meet shareholder number requirements or attempt to get the required 100 percent shareholder approval.

Shareholders may enter agreements that place limits on their ability to sell their stock. In addition, the mechanics of a conversion will require some special expertise for the bank in tax law and accounting. The change from the reserve method to the specific charge-off method for bad debts or the existence of net operating losses may present unique circumstances for each institution.

Bank portfolios also may undergo changes prompted by shareholders' requests. An example might be increased purchases of tax-free securities to meet the desires of shareholders for more tax-free interest. Another may arise from a tendency to remove accumulated earnings to pay personal taxes as the corporation generates earnings. This could place a strain on capital when growth is strong or delinquent assets are rising.

Other Drawbacks

To receive the benefits of the subchapter "S" election,

the institution will need to meet all the eligibility requirements for every day of the tax year. Furthermore, the IRS has not yet resolved all the tax issues related to the subchapter "S" election on the part of financial institutions. Specific guidelines from the IRS are expected by year-end 1996 which may affect an institution's decision to elect subchapter "S" status.

The states of Connecticut, Michigan, New Hampshire, New Jersey, Tennessee as well as the District of Columbia do not recognize the federal subchapter "S" election. Therefore, these jurisdictions do not allow the pass-through benefits of the "S" corporation for the applicable state or district taxes.

Subchapter "S" institutions remain under the same capital adequacy standards and dividend restrictions as other institutions. However, there are times when it may be difficult to maintain the subchapter "S" status. An example would arise when an institution needs to raise capital to meet Prompt Corrective Action (PCA) guidelines. *To meet the IRS requirements for subchapter "S" election while raising the necessary capital, current shareholders may have to be the primary source of new capital.* The ability to raise additional capital by attracting new eligible shareholders may be difficult because the total number of eligible shareholders must remain 75 or fewer to preserve the "S" status. Furthermore, no new classes of stock may be issued. Violation of any of these criteria would result in the loss of the subchapter "S" status and reversion to regular corporate tax rules.

Distributions to shareholders are covered by similar restrictions for subchapter "S" corporations as for regular corporations. However, one possible new twist is that, in some cases, the tax liability payment for shareholders may be due before distributions are funded from the institution. However, this is considered similar to pressures brought by shareholders in other corporations when they require dividend pay-

ments to fund debt payments on stock loans.

New Value for the Community Bank Charter

Overall, this newly legislated tax break for closely-held financial institutions may invigorate the value of the community bank or thrift. However, it also adds a new "wrinkle" in the complexity of the examiner's job. While consolidation trends can be expected to continue at larger companies, the new tax benefits available for closely-held institutions add a new incentive for the survival of community banks and thrifts.

*Ronald L. Spieker, Chief,
Depository Institutions Analysis Section*

*

There may be a rise in various "phantom bank mergers" or change in control applications as the companies work to meet shareholder number requirements or attempt to get the required 100 percent shareholder approval.

For More Information

Subchapter S Election for Federal Income Taxes.
FIL-91-96.

* Extensive review and comments were provided by Robert F. Storch, Chief, Accounting Section of the Division of Supervision.

Savings Association Insurance Fund (SAIF) Capitalized

FDIC Lowers Assessment Rates

- SAIF was capitalized through a \$4.5 billion special assessment. Over 150 banks and thrifts in the San Francisco Region paid \$1.4 billion of this total.
- Bank Insurance Fund (BIF) members will bear part of the cost of the Financing Corporation (FICO) bonds beginning in 1997.
- The special assessment negatively affects 1996 operating performance, but earnings prospects are greatly enhanced by a proposal to lower future SAIF assessment rates.

Why Was Action Needed?

After more than two years of hard work by regulators, Congress, and the banking and thrift industries, the Deposit Insurance Funds Act of 1996 (Act) was passed to address the serious problems of the SAIF.

The difficulties facing the SAIF were substantial and demanded a solution. They primarily fell into the following areas:

- SAIF was undercapitalized and there was concern that one large, or several sizable, thrift failures could quickly deplete the fund balance. Its balance was \$3.9 billion, or 0.55 percent of insured deposits, on June 30, 1996, well below the target reserve ratio of 1.25 percent of insured deposits.
- Over 45 percent of SAIF assessments were being diverted from the SAIF to pay off FICO obligations arising from the thrift failures of the 1980s.
- The SAIF assessment base continued to shrink, with a 22 percent reduction noted from year-end 1989 to June of 1996.
- Disparity between SAIF and BIF premiums created strong economic incentives for institutions to

Over 56 percent of the San Francisco Region's institutions paying the special assessment posted a quarterly net operating loss for the third quarter of

TABLE 1

SAN FRANCISCO REGION INSTITUTIONS AFFECTED BY SPECIAL ASSESSMENT							
NUMBER OF INSTITUTIONS AFFECTED AND TOTAL ASSESSMENT BY TYPE	MUTUAL	SAVINGS	S&L	STATE	NATIONAL	NON-	TOTAL
	BANKS	BANKS		MEMBER		MEMBER	
ALASKA	0	0	1	0	0	0	1
ARIZONA	0	2	0	0	2	1	5
CALIFORNIA	0	44	28	1	7	14	94
GUAM	0	0	2	0	0	0	2
HAWAII	0	2	3	0	0	0	5
IDAHO	0	1	3	0	0	0	4
MONTANA	0	5	4	0	0	0	9
NEVADA	0	1	0	0	0	1	2
OREGON	0	4	4	0	0	2	10
UTAH	0	1	2	0	0	0	3
WASHINGTON	9	3	8	0	1	2	23
WYOMING	0	3	1	0	1	2	7
TOTAL	9	66	56	1	11	22	165
ASSESSMENT (\$000s)	57,516	920,374	265,994	253	67,910	45,998	1,358,045
SOURCE: DERIVED FROM EARLY ESTIMATES FROM THE FDIC'S DIVISION OF FINANCE.							

transfer SAIF-assessable deposits to affiliated institutions insured by the BIF, contributing to the shrinkage in the SAIF assessment base.

What Significant Actions Were Taken?

Special Assessment: In order to address the immediate problems, the Act required the FDIC Board of Directors to impose a special assessment of approximately 65.7 basis points on SAIF-member institutions. The special assessment was designed to increase the fund's level to 1.25 percent of insured deposits effective October 1, 1996. In determining the amount, the Board:

- Exempted weak and other specifically defined institutions from paying the special assessment.
- Decreased by 20 percent the amount of SAIF-assessable deposits against which the special assessment will be applied for certain Oakar and other institutions. (An Oakar institution is a member of one insurance fund that has acquired deposits insured by the other fund. The acquired deposits retain coverage under the seller's fund.)

Early estimates are that there will be fewer than fifteen exempted institutions in the San Francisco

Region. This number of exempted institutions is small compared with the estimated 160-170 institutions in the Region that paid about \$1.4 billion to the SAIF in November. As Table 1 (previous page) indicates, the special assessment affects more than just thrifts. This is due to the substantial number of banks that have acquired SAIF deposits through acquisitions or branch purchases over the last few years.

FICO Costs: The recently enacted legislation also addressed another legacy of the problems thrifts experienced in the 1980s -- FICO bonds issued in 1987 to help shore up the former Federal Savings and Loan Insurance Corporation (FSLIC). The cost of financing this debt, about \$800 million per year, was a major reason the SAIF had not improved as quickly as the BIF.

The Act authorized FICO to impose periodic assessments on BIF members in addition to members of SAIF that were already being assessed. The FICO charge on BIF-assessable deposits must be one-fifth the charge on SAIF assessable deposits. As a result, *the FICO charge on SAIF-assessable deposits for the first semi-annual assessment period of 1997 will be 6.48 basis points (annualized), and the charge on BIF-assessable deposits will be 1.30 basis points* (see Table 2). As necessary, FICO rates will be adjusted on a quarterly basis to reflect changes in the assessable-deposit bases for the BIF and the SAIF. Beginning on January 1, 2000, or, when the insurance funds merge, whichever occurs earlier, BIF and SAIF members will share the FICO assessment on a pro rata basis. (FICO assessments will be paid in addition to the deposit insurance assessments. See discussion below.)

Final Rule to Lower SAIF Assessment Rates: With the SAIF now capitalized by the special assessment, the FDIC Board lowered the rates on ongoing assessments paid to the SAIF. The FDIC Board also widened the spread between the lowest and highest rates to improve the effectiveness of the FDIC's risk-based premium system.

The final rule establishes an adjusted SAIF rate schedule of 0 to 27 basis points effective for all non-exempt institutions beginning January 1, 1997. (Since only SAIF-member savings associations must, by law, pay for FICO assessments until the end of 1996, a special interim rate was established for SAIF-member savings associations for the last quarter of 1996.)

As is noted in Table 2, institutions exempted from paying the special assessment will not benefit initially from the lower SAIF assessment rates. They will pay according to the 23- to 31-basis point schedule through year-end 1999, unless they choose to make a pro rata

TABLE 2

SUMMARY OF 1997 ASSESSMENT RATES *			
1997 ADJUSTED BIF & SAIF SCHEDULE			
CAPITAL GROUP	SUPERVISORY SUBGROUP		
	A	B	C
1	0	3	17
2	3	10	24
3	10	24	27
EXEMPT INSTITUTION SAIF SCHEDULE			
1	23	26	29
2	26	29	30
3	29	30	31
FICO ANNUAL RATES			
BIF INSTITUTIONS		SAIF INSTITUTIONS	
1.30		6.48	
* CENTS PER \$100 OF DOMESTIC DEPOSITS			
SOURCE: FDIC'S DIVISION OF INSURANCE			

payment of the special assessment in the interim.

Implications for Insured Institutions

Institutions that are required to pay the SAIF special assessment should have accrued a liability and an offsetting noninterest expense as of September 30, 1996. As a result, many such institutions will reflect much lower operating earnings this year. In fact, over 56 percent of the San Francisco Region's institutions that paid the special assessment posted a quarterly net operating loss for the third quarter of 1996 primarily due to the special assessment.

Concerns over the short-term financial impact described above are moderated by much brighter future prospects. First, the special assessment is a one-time charge and should not affect future earnings streams of nonexempt institutions. Second, the proposed lower SAIF assessment rates should actually help to boost net income in 1997. Finally, some observers have noted that the resolution of the SAIF's deficiencies should remove uncertainties that may have depressed stock prices of SAIF-member institutions. Over the longer-term, the capitalization of the SAIF and the change in assessment rates also pave the way for a dialogue about a possible merger of the two deposit insurance funds.

John D. Weier, Chicago Senior Regional Analyst
For More Information

- SAIF Assessments. FIL-88-96
- Accounting for the SAIF Special Assessment and

- FICO Assessments. FIL-90-96
- Federal Register 61, No. 201, pp. 53834-53841: Assessments.
- Federal Register 61, No. 201, pp. 53867-53876: Proposed Rules - Assessments.
- Press Release 79-1996 and 63-1996.
- Chairman Helfer's Speeches: July 19, 1996, and October 28, 1996.

San Francisco Region Continues to Record Rapid Growth

- The San Francisco Region continues to set the pace in employment growth. The six fastest growing states in the nation are all located in the Region -- Nevada, Utah, Arizona, Oregon, Idaho, and Washington. As of November 1996 these six states each recorded employment growth rates of 4.0 percent or better over the last year.
- The resurgence of California, where the recovery has been picking up steam, is being helped by strong growth in the service sector. Services continue to lead the expansion in much of the Region. Strength in manufacturing and construction also are fueling growth.
- Although much of the Region has made significant progress in commercial real estate, it remains a problem in several markets. Furthermore, rapid growth in construction activity in several states is raising concerns about the sustainability of the boom, especially in light of a possible slowdown in population migration from California to other western states.
- Finally, Hawaii is experiencing a prolonged recession, while two states that are relatively dependent on natural resources, Alaska and Wyoming, have fallen well behind the national expansion.

Rapid Job Growth

The Region's economy continues to outperform the nation in creating jobs. Nevada and Utah are setting the pace for the Region. Despite some evidence in recent months of a moderation in growth rates for several states, employment in the Region still is growing much faster than the nation. Furthermore, most state level indicators and many forecasters in the Region point to a continuation of favorable conditions across most states in the Region, although many analysts expect growth rates to moderate in 1997.

Services, which include an array of activities from business, professional and health services, to educa-

tion, entertainment and lodging, continue to pace the expansion in the Region. As the largest employment sector, services account for about 30 percent of all jobs in the Region.

Manufacturing in the Region is being boosted by a strong turnaround in aircraft orders, strength in electronics and favorable export market conditions for many high-tech products. This sector, with a 13 percent share of employment, continues to boost growth in the Region, especially in the Pacific Northwest, and has been surprisingly strong in California.

Much of the Region has made significant progress in the real estate area. However, commercial real estate

CHART 1

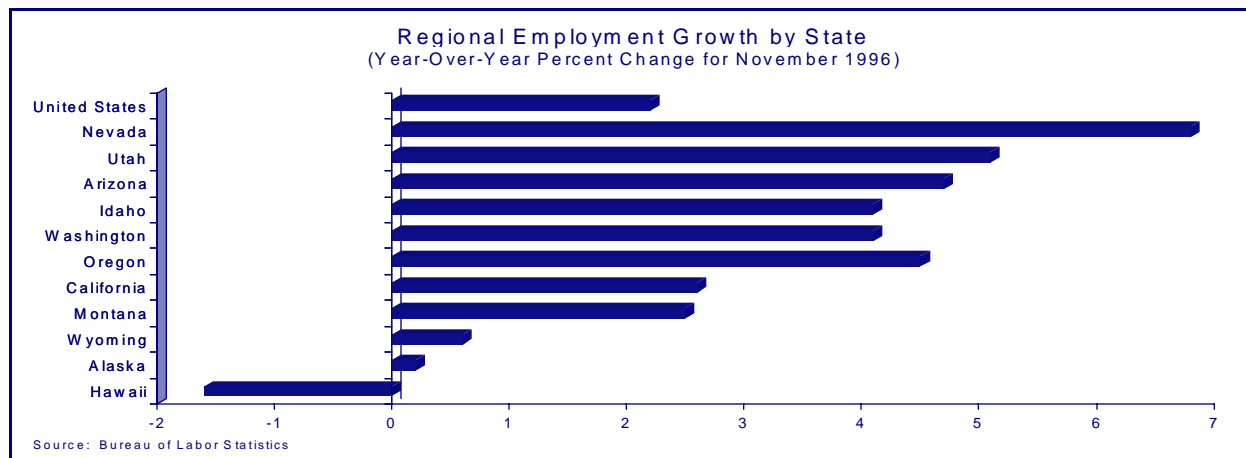
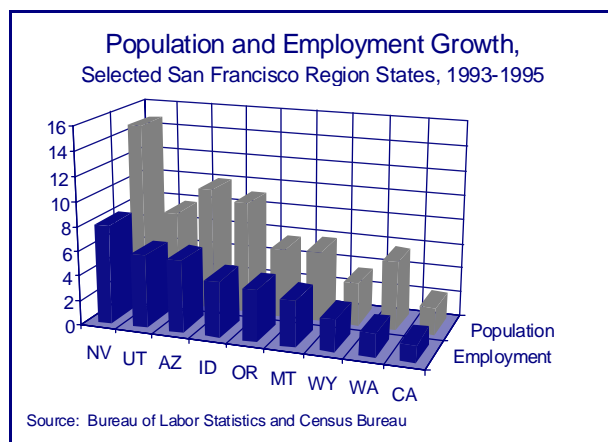


CHART 2



continues to be an issue, especially in Southern California and Hawaii. Another concern for the Region is that the renewed prosperity of California could stem the population outflow to other states, an exodus that has stimulated much of the West in recent years. This could slow the boom in construction in fast growing states like Nevada and Utah.

The Six Stars: Nevada, Utah, Arizona, Idaho, Washington and Oregon.

These six states recorded employment growth rates two to three times faster than the nation over the twelve months ending in November 1996. Nevada and Utah, with total nonfarm payroll employment growth rates of 6.8 and 5.1 percent, respectively were the fastest growing states in the nation, although both grew even faster in 1995. The other four rapidly growing states, Arizona, Ore-



gon, Idaho and, Washington all created at least 4 percent more jobs over the last year, about twice the national rate of increase (see Chart 1 previous page).

Among this group of fast growing states, three sectors stand out -- services, manufacturing and construction. Each of the states is reporting rapid growth in service jobs, at rates of close to 5 percent or better over the last year. All have experienced relatively strong manufacturing growth compared to the nation. Finally, with the exception of Washington, each of these states also has recorded rapid growth in the construction sector. As is noted in ***Region Outperforms Nation Despite Sight Decline in Profitability***, reliance on the construction sector is of concern because banks in several states have increased their exposure to construction lending over the last year. *This concern is especially true at smaller institutions, banks with assets under \$1 billion, where exposure to construction lending is more than twice the national average in Arizona, Oregon and Washington, and more than four times the national average in Nevada.*

Nevada's robust performance as the nation's fastest growing state in part can be attributed to its rapid population growth. Chart 2 focuses on the strong relationship during the 1993-1995 period between population growth and employment growth in selected western states. Population growth also has fueled the state's booming construction industry, especially in the Las Vegas market. In 1996 construction of new air terminals in Las Vegas boosted commercial construction activity, while residential construction activity continued its steep climb.



CHART 3A

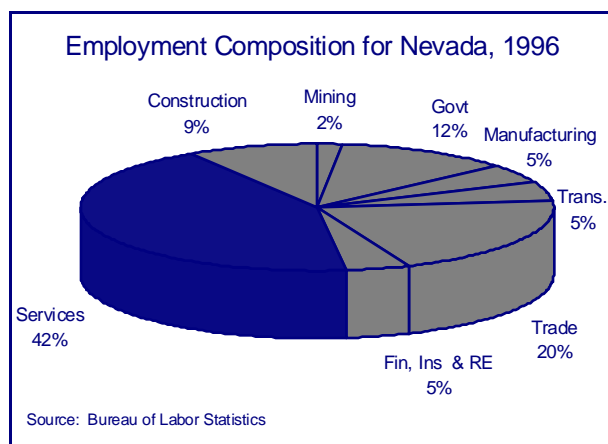
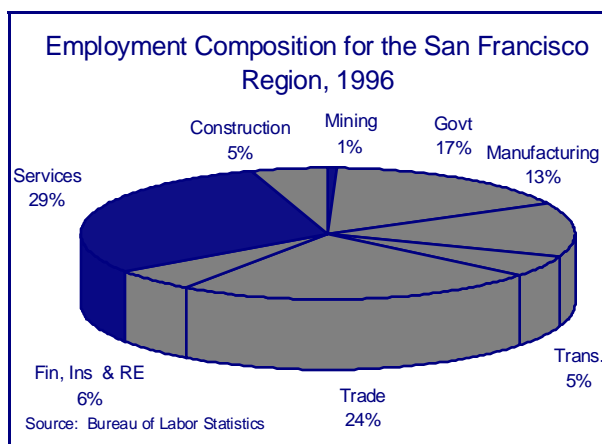


CHART 3B



Several factors suggest caution with respect to the health of the Nevada economy. Slower growth in the service sector also is a cause for concern in Nevada because service jobs account for 42 percent of the state's payroll employment, compared to 29 percent for the nation. Expansion in the service sector, which includes the state's gaming industry, has slowed to 4.8 percent over the last twelve months from over 10 percent in 1994. Service jobs are now growing at the slowest rate in more than three years, mainly as a result of softness in the key hotel and amusement industry on which the state is heavily dependent.

Nevada is heavily reliant on the building industry, as is shown in Charts 3a and 3b (previous page), which show a comparison of Nevada and the Region's employment composition. Construction jobs accounted for almost 9 percent of employment in the state at the end of the third quarter of 1996, almost twice the 4.5 percent share for the industry nationally and well above the Region's 4.9 percent share. Since construction employment growth has slowed in recent months and the state is so heavily dependent on construction, the softening could have an impact on the overall state economy. Furthermore, there also has been a slight

rise over the last year in the office vacancy rate for Las Vegas. Still, as can be seen from Table 1, vacancies in Las Vegas remain below the national average.

A construction slowdown in particular would have a significant impact on the health of Nevada's non-credit-card banks and thrifts because of their relatively heavy concentration in commercial real estate lending. For example, banks with assets under \$1 billion, have more than *four times* as much exposure to construction lending as banks elsewhere in the nation. These factors suggest that conditions in the nation's fastest growing state should be carefully monitored.

Utah, the nation's second fastest growing state, recorded strong job growth in all major sectors except governmental services over the last year. Transportation, finance and manufacturing all reported rapid growth. Strength in business services and telemarketing helped sustain favorable growth in the service sector.



TABLE 1

OFFICE VACANCY RATES SHRINKING IN MOST MARKETS						
	1991	1992	1993	1994	1995	1996 THROUGH 3Q
SALT LAKE CITY	19.1	19.8	14.6	8.6	6.6	5.8
PORTLAND	15.7	14.4	12.9	9.8	8.8	7.4
SAN FRANCISCO	13.7	12.6	12.4	10.1	9.2	6.8
SEATTLE	13.0	13.6	13.2	12.8	10.1	9.2
SACRAMENTO	13.7	15.8	16.8	13.4	11.8	9.9
LAS VEGAS	12.0	12.6	11.1	7.8	9.3	10.6
PHOENIX	26.0	24.0	20.1	16.6	13.0	10.6
TUCSON	23.3	22.8	20.5	16.0	11.8	11.0
ORANGE COUNTY	21.4	20.4	17.2	16.7	16.0	14.1
HONOLULU	4.4	7.3	10.2	12.3	13.6	14.9
SAN DIEGO	22.2	23.5	21.4	18.6	17.9	15.6
LOS ANGELES	19.1	19.7	19.9	20.1	19.3	19.2
UNITED STATES	19.0	19.0	17.7	16.1	14.6	13.2
NOTE: DATA COVER THE METROPOLITAN AREA AND ARE AVERAGE FOR THE PERIOD. SOURCE: CB COMMERCIAL PROPERTY INFORMATION SYSTEMS						

Like Nevada, Utah also is relatively heavily dependent on the construction sector, which in the past has tended to move closely with the state's business cycle. Salt Lake area industrial vacancy rates have risen noticeably over the last year, although at 5.8 percent in the third quarter, they are still well below the 7.7 percent rate for the nation. In the office market vacancy rates are less than half of the national average. Still, the sharp third quarter reduction in growth rates for both new awards for nonresidential construction and residential building permits should be monitored carefully in the months ahead.

Arizona's 4.7 percent job growth over the last twelve months also was broad based. Construction and services were the fastest growing sectors, both added new jobs at more than a 5 percent rate over the last year. The state also is showing strength in the manufacturing of aerospace equipment, electronics and machinery.



There are some concerns that commercial real estate markets in Arizona are providing mixed signals. Some analysts have expressed concerns that the retail sector may be overbuilt. Industrial vacancy rates also have risen sharply over the last year and now exceed the nationwide average. Still, Arizona's market for office space appears to be faring better than the nation, as vacancy rates remain below the national average.

Expansion in the service sector played an important role in the strong performance of Oregon's economy over the last year. Service jobs grew at a rate of 7.5 percent in Oregon and accounted for the bulk of new jobs in the state. The Oregon economy has seen rapid increases in construction-related employment, too. Manufacturing employment also expanded at a moderate pace over the last year, while forest products stabilized after falling sharply in 1995. In contrast to the mixed signals in some other states, the construction industry in Oregon continues to expand rapidly. Commercial real estate is being boosted by the construction of several large high-tech manufacturing plants. Growth in employment in **Idaho** softened over 1996, especially in the last half of the year, and other signs of slowing are appearing as well. For example, recent announcements of layoffs in high tech manufacturing and a projected state budget shortfall are raising concerns about Idaho's ability to maintain the expan-



sion at the current pace next year. While recent increases in manufacturing were important in counteracting job losses in electronics and food processing, the increased volatility in Idaho's growth rate, coupled with job losses in recent months in both services and construction, suggest that further slowing may be ahead for the state.



Manufacturing is having its strongest impact in **Washington**. Boeing is building up a huge backlog of aircraft orders that has stimulated production and boosted employment over the last year. Meanwhile, the rapidly expanding service sector in Washington was paced by robust advances in business and computer services. The surge in demand for labor also appears to be putting pressure on the housing market in the Seattle area.



While the other fast growing states in the Region are expected to slowdown somewhat in 1997, the **Western Blue Chip Economic Forecast** is predicting even faster growth in 1997 for the Washington economy, which ranked sixth in the nation in job growth in 1996. Key industries like aerospace and software are expected to continue to lead the state's growth.

California Is Back in Business

The resurgence of the large California economy has boosted the overall pace of growth for the Region. The state accounts for more than 10 percent of national employment, and as of November, employment was growing at a significantly faster pace (2.6 percent over the last year) than the national economy (2.2 percent). Those jobs helped drive the state's unemployment rate down to 6.9 percent, a major improvement from the 8.0 percent unemployment rate one year earlier.



The state's service sector, with nearly 31 percent of California's jobs, has been critical to the rebound. Service jobs increased 4 percent over the last twelve months, and growth is expected to remain strong in 1997. Services added almost 153,000 jobs during the last twelve months, nearly half of the state increase. Tourism and entertainment continue to be a positive influence on service

sector employment. In addition, large increases were recorded in the trade, manufacturing and construction sectors. Finally, the recently proposed Boeing-McDonnell Douglas merger also may help to stabilize the Region's important aerospace industry.

The Bay Area, fueled in part by a strong performance in the Silicon Valley, which is experiencing an export boom, is outperforming much of the rest of the state. Growth in the Central Valley and Southern California continues to lag behind the recovery in other parts of the state.

Southern California Continues to Lag

In addition to weaker employment growth, Southern California continues to report soft housing and commercial real estate markets. On the residential side, much of the Los Angeles area still is reporting moderately lower housing prices and weak sales. The *Real Estate Research Council* reported in October that Southern California housing prices were down 1 percent from a year earlier. Over the same period, prices fell by closer to 2 to 3 percent in the Riverside-San Bernadino and Los Angeles markets. On the commercial side, the key Los Angeles metropolitan area is reporting a very high office vacancy rate, 19.5 percent in the third quarter. Industrial vacancy rates for Southern California, at 11.3 percent for the third quarter, also are well above the 7.7 percent national average.

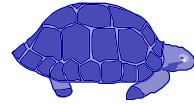
Implications: *Southern California continues to expand, but more slowly than most other Regions of the state.* Although conditions clearly have improved in many areas, difficulties in this major metropolitan real estate market continue to put pressure on commercial real estate values, property owners and lenders. Despite the lingering problems the state's outlook for continued growth looks sound.

Lagging Well Behind the Region

Montana, Wyoming, Alaska and Hawaii have lagged well behind the pace set by the rest of the Region. Of the four, **Montana's** economy has fared the best, with employment growing a little faster than the rest of the nation, and the unemployment rate remaining well below the national average. Like its faster growing brethren, the state has benefited from strong growth in the service

sector and improvement in communications and technology-based manufacturing.

In contrast, employment growth in both **Wyoming** and **Alaska** stagnated over the last twelve months.



Both states appear to have been hurt by their dependence on the natural resources sector, a factor that suggests they may not experience a rapid improvement in fortunes in 1997. Wyoming has suffered from continuing softness in agriculture, livestock, energy and the timber industry. In addition, the Alaskan fishing industry also has been hurt by low prices for the key salmon harvest. One positive note in Alaska has been a pick up in tourism, as both cruise ship traffic and the state's visitor count improved in 1996.

Tourism also is providing a stimulus to a **Hawaiian** economy that has remained mired in recession for four years. The state is experiencing both increased visitor counts and higher levels of spending by tourists. Despite the stimulus from tourism, over the last year employment fell by 1.6 percent, and Hawaii ranked next to last nationally in employment growth. Commercial office vacancy rates are very high, at 14.9 percent for the first three quarters. In addition, both construction contracts and housing permits have fallen dramatically over the last year and they are showing no evidence of a turnaround.

Implications: The ongoing economic downturn and deterioration in the Hawaiian real estate markets is causing the state's financial institutions to record lackluster performances. Hawaii's economic difficulties have driven up problem loan ratios and dampened the performance of the state's banks and thrifts.

Gary C. Zimmerman, Regional Economist

Financial and Commodity Markets

- The Treasury yield curve remains steeper than at the beginning of 1996, but it has flattened since July.
- The San Francisco Region's bank stock index has outperformed the S&P 500 so far this year, but it has underperformed the S&P Composite Bank Index.
- Evidence suggests that changes in the slope of the short-end of the yield curve may be a good predictor of bank stock performance relative to the broader market.
- New yield curve spread futures and options offer an alternative to managing exposures to twists in the yield curve.
- Favorable forecasts and a drop in exports have driven grain prices lower.

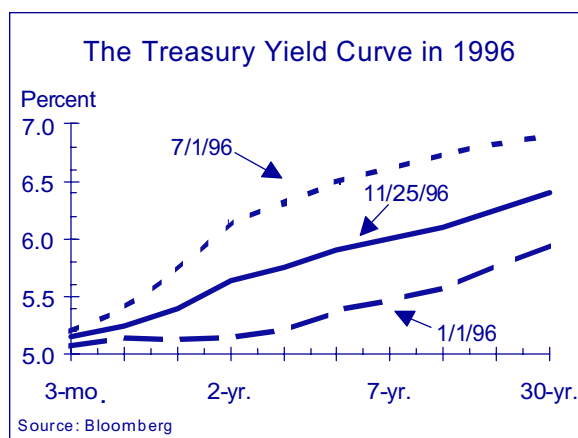
Changes in Interest Rates and Bond Values

As reflected in Chart 1, the yield curve has steepened and then flattened this year. The 30-year Treasury yield peaked on June 12 and July 5 at 7.19 percent -- 124 basis points higher than at the beginning of 1996. It has since fallen to 6.40 percent.

To demonstrate the impact that interest rate fluctuations may have had on the market value of a bank's fixed income portfolio, Table 1 presents three types of fixed income securities common to a bank's portfolio: a Treasury bond, a FNMA mortgage pass-through, and a callable FNMA Agency bond. The value of each bond was computed on January 1, July 1, and November 25, 1996. Table 1 lists the percent change in the value of each bond between those dates.

Together the bonds lost nearly 5.27 percent of their value through July 1, 1996, but they recovered 2.74 percent by November. Through the eleven months ending in November, the value of the three-bond portfolio was down 2.68 percent. On an aggregate basis, the San

CHART 1



Francisco Region's banks fared better. The value of securities holdings for all Call Report filers in the Region decreased by 0.92 percent for the nine months ending in September. Obviously each institution's investment portfolio performance will vary depending on the types of instruments held and the original acquisition

TABLE 1

EXAMPLE OF RECENT BOND PERFORMANCE								
	US TREASURY 30-YEAR BOND \$100,000 PAR 7.25% COUPON 7.75 YRS UNTIL MATURITY		FNMA MORTGAGE PASS-THROUGH \$100,000 PAR 7.5% COUPON 7.59 YRS WAL		FNMA CALLABLE AGENCY BOND \$100,000 PAR 7.55% COUPON 7.58 YRS UNTIL MATURITY		TOTAL	
DATE	PRICE	CHANGE FROM PRIOR PERIOD	PRICE	CHANGE FROM PRIOR PERIOD	PRICE	CHANGE FROM PRIOR PERIOD	PRICE	CHANGE FROM PRIOR PERIOD
11/25/96	\$107,375	3.84%	\$100,280	2.19%	\$102,240	2.14%	\$309,895	2.74%
7/1/96	\$103,406	(7.08%)	\$98,130	(3.90%)	\$100,100	(4.68%)	\$301,636	(5.27%)
1/1/96	\$111,281		\$102,110		\$105,020		\$318,411	

SOURCE: Bloomberg

price of each instrument.

The San Francisco Region's Bank Stock Performance

The stock market generally reacts unfavorably to rising interest rates, and reflecting this, the S&P 500 gained only slightly more than 3 percent through July (the latest peak in long-term rates). Since July the decline in rates has propelled the S&P 500 to new record levels, up 21 percent this year. The S&P Bank Index, however, has performed well for most of the year, despite the period of rising rates that occurred during the first two quarters of 1996.



The stellar performance of the money center banks this year -- with Citicorp and Chase Manhattan alone up over 60 percent on the year -- caused the S&P Bank Index to outperform indexes that track the performance of the San Francisco Region's banks. The San Francisco Regional Bank Index (SFRBI), created by the Division of Insurance (DOI), consists of the San Francisco Region's 23 members of the American Banker Bank Index, which includes the 225 largest publicly-traded banks or bank holding companies. *The SFRBI, which is weighted by total market value of shares outstanding, has gained 34 percent on the year, with performance closely tracking the S&P Bank Index.* The SFRBI shares its three largest institutions with the S&P Bank Index: BankAmerica Corp., US Bancorp, and Wells Fargo & Company.

Do Yield Curve Spreads Provide a Peek at Future Bank Stock Performance?

A recent study by Merrill Lynch suggests that the slope of the short-end of the yield curve is a useful predictor of near-term bank stock performance relative to the broader market. For the period 1950 through 1995, the median performance of bank stocks in the study's universe outperformed the broader S&P 500 index 76 percent of the time in the twelve months following a widening of spreads between the 5-year and 3-month Treasuries. In contrast, the median underperformed the broader market 75 percent of the time in the twelve months following compression in the 5-year and 3-month spread. Chart 3 on the following page plots this concept through 1995.

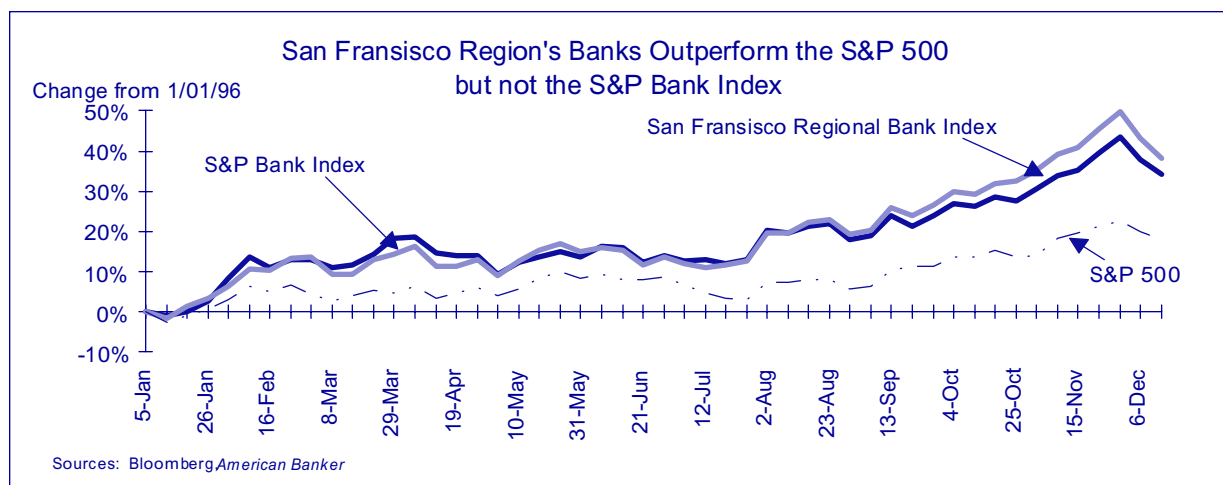
The results of this study are intuitive. A steepening yield curve favors widening interest margins. The opposite is true as the yield curve flattens.

Did the change in the 5-year/3-month spread over the previous year portend the recent strength in bank stocks? Not in this case. For the twelve months ending October 1996, bank stock performance relative to the broader market was strong despite a decline of nearly 200 basis points in the 5-year/3-month spread during the preceding twelve months.

This recent departure from the historical pattern may have resulted from the market's recognition of widespread cost-cutting and "right-sizing" programs, as well as merger and acquisition activity. Also, bank stock performance has been buoyed by the use of excess funds to repurchase outstanding shares at many institutions, which drives earnings per share higher.

A New Product for Managing Exposures to Yield

CHART 2



Curve Twists

Managing earnings exposures to changes in the yield curve typically requires altering cash market positions, executing customized financial derivatives, or contracting multiple positions in exchange-traded derivatives instruments. Recently, the Chicago Board of Trade (CBOT) introduced new products that may eventually simplify managing this risk -- Yield Curve Spread Futures and Futures Options (YCSF).



YCSF contracts are structured so the payoff changes only in response to changes in spreads between points along the Treasury yield curve, rather than shifts in the overall level of interest rates. These instruments may provide advantages over hedges involving multiple positions in interest rate derivatives that attempt to isolate spreads along the yield curve. Ten futures contracts with spreads that cover the 2-, 3-, 5-, 10-, and 30-year maturity points were initially approved for trading. Options on these contracts also are traded.

In theory, YCSFs could be used to construct hedges for specific interest-sensitive securities, or more macro hedges based on an institution's overall balance sheet structure. Regardless of how they are used, a great degree of sophistication would likely be needed to construct meaningful hedges. Insured institutions that execute YCSF contracts should be cognizant of the fundamental risks identified in the FDIC's supervisory policy addressing financial derivatives.

Initial trading in the YCSFs has been thin and for some contracts non-existent. A CBOT representative indicated that position holders have been fairly diversi-

fied with most volume being derived from speculators and traders for proprietary accounts.

Favorable Forecasts, Fewer Exports Drive Grain Prices Lower

Many market observers were surprised by a mid-November USDA report that projected near-record corn and soybean crops this year. Favorable weather during the late harvest pushed estimated corn production for the 1996/1997 crop year to 9.27 billion bushels -- the third best harvest behind those of 1992 and 1994. The USDA expects strong corn yields over much of the Corn Belt and record yields in Nebraska, Kansas, and Missouri. Likewise, soybean production is forecast to total 2.4 billion bushels -- second only to the 1994 harvest.



As expected, prices for corn continued to slide from their summer highs, which were driven by fears of supply shortages, late planting, and late harvest risks. Weaker corn and soybean prices, the second largest spring wheat harvest on record, and favorable weather conditions for the recently planted winter wheat crop also have softened wheat prices (see Chart 4 next page). Further compounding price declines has been a drop in demand from abroad as global competition heightens. Domestic corn and wheat producers are facing increased production, aggressive marketing, and foreign export subsidies from competitors including Argentina and the European Union. Soybean exports appear more favorable as Pacific Rim purchases of soybean meal to feed expanding livestock herds accelerate and as South American competitors face lower than expected production.

CHART 3

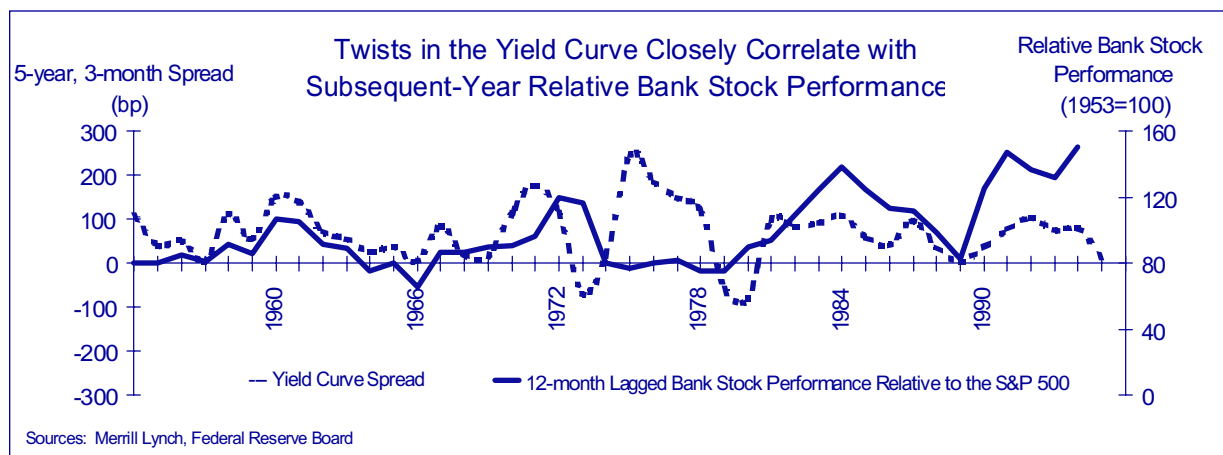
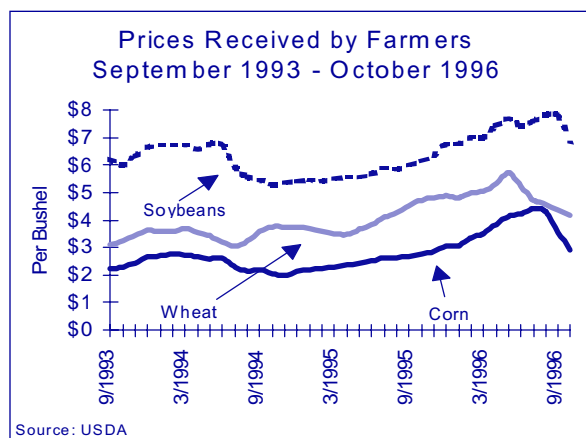


CHART 4



According to the USDA, average prices for all three crops for the current marketing year are expected to fall from the average of the previous year, but should remain favorable relative to the average price received over the previous five marketing years. Futures markets generally agree with these predictions with some contracts that mature over the 1996/1997 marketing year recently trading approximately 30 percent below their respective

contract highs reached earlier in the year.

Provided livestock and milk prices continue their recent ascent or stabilize, declines in feed costs should improve profit margins for livestock and dairy farmers. This is especially good news for cattle operators who faced falling cattle prices and rising feed costs earlier in 1996. Table 2 shows the top agricultural commodities for each state in the San Francisco Region.

The prospect for timely repayment of production loans to the Region's agriculture banks appears good based on the current expectations for operating income. Cash flows for many wheat and cotton producers also should be supported by the first of seven fixed-support payments under the 1996 Farm Bill.

Allen Puwalski, Banking Analyst
Steven E. Cunningham, Senior Financial Analyst

TABLE 2

TOP AGRICULTURAL COMMODITIES IN THE SAN FRANCISCO REGION BASED ON 1994 CASH RECEIPTS										
	AK	AZ	CA	HI	ID	MT	NV	UT	WA	WY
CATTLE	5	1	4		1	1	1	1	1	1
DAIRY	2	3	1	5	3		3	2	3	
HAY	3					4	2	3		3
GREENHOUSE & NURSERY	1		2	3			5	5		
POTATOES	4				2		4		5	
WHEAT					4	2			4	
SUGAR BEETS					5	5				2
COTTON		2	5							
BARLEY						3				5
SUGAR CANE				1						
PINEAPPLE				2						
APPLES									2	
GRAPES			3							
LETTUCE		4								
SHEEP AND LAMB										4
TURKEYS								4		
LEMONS		5								
MACADEMIA NUTS				4						
SOURCE: USDA										

Region Outperforms Nation Despite Slight Decline in Profitability

- Core earnings of most insured institutions remain solid; however, third-quarter operating performance at a number of savings institutions was negatively affected by the SAIF special assessment.
- There are signs of a pickup in lending for consumer credit, construction, and commercial real estate.
- Credit card delinquency and charge-off rates continue to increase and have begun to push up problem loan ratios. Bank earnings also were negatively affected by higher provisions to cover rising charge-offs

Overall Conditions

Although both balance sheets and examination ratings portray an improving industry, there are some areas of special interest this quarter. One area, recognition of the SAIF special assessment, was an isolated event and, though somewhat painful, is recognized as the answer to previously identified insurance fund problems (see *SAIF Capitalized*). Other areas, such as stubbornly rising consumer loan losses, particularly in credit cards, commercial real estate and construction lending trends, and lingering weaknesses in the Southern California economy, cause some concern about future asset quality. In addition, during the past six months, field examiners continued to express a higher level of concern regarding overall risks in lending practices by banks in the San Francisco Region as compared to banks elsewhere in the nation.

Third-Quarter Losses Reflected at a Number of Institutions in the Region

While most banks and thrifts reported solid earnings, operating performance for a number of the San Francisco Region's insured savings institutions was dramatically affected by the recognition of the SAIF special assessment. This third quarter charge of \$1.4 billion appears to be the primary factor in quarterly operating losses at 95 institutions. In contrast, only 39 also reported year-to-date losses. Both banks and thrifts were affected; however, the Region's 120 thrifts absorbed \$1.2 billion or 87 percent of the cost. As a result, *Thrift Financial Report (TFR)* filers actually posted an aggregate \$413 million loss for the third quarter and recognized only \$486 million in net income for the first three quarters of 1996, or an estimated 0.24 percent return on assets (ROA) based on TFR data. This compares to a \$1.1 billion profit or 0.49

percent ROA for the same period in 1995. Since the special assessment was a one-time charge, profitability for these institutions is expected to improve next quarter and will likely be further enhanced in 1997 due to lower assessment rates approved by the FDIC.

Profits at banks in the San Francisco Region declined moderately in the third quarter as merger related overhead costs climbed 8 percent and provisions jumped 36 percent to cover higher credit card losses. ROA dropped from 1.44 percent on September 30, 1995 to 1.25 percent for September 30, 1996. *Despite this downturn, the Region's banks as a whole continue to outperform the nation, which averaged an ROA of 1.19 percent.* Only three states in the Region lag the national averages: Arizona at 1.02 percent, California at 1.07 percent, and Hawaii at 1.00 percent.

Over the last year banks in the San Francisco Region relied more heavily on two key sources of relatively more expensive purchased funds -- large time certificates of deposit and foreign borrowings -- a factor that likely keeps the pressure on net interest margins and earnings. These two sources accounted for the bulk of the Region's banks' \$30.3 billion or 6.8 percent increase in deposits over the last four quarters. Banks added \$8.6 billion in large CDs and \$7.4 billion in foreign deposits, growth rates of 24.1 and 15.4 percent, respectively.

Net changes in the key sources of traditional retail deposits, NOWs, Savings/MMDAs and small-denomination time certificates, were modest over the last year, an increase of \$2.5 billion or 1.0 percent. However, within this category there were some dramatic shifts, although they likely arose as banks took actions designed to reduce their need to hold reserves against deposits at the Federal Reserve.

In this Region a number of large institutions have instituted deposit sweep programs that shift funds

from transaction accounts on which banks must hold noninterest-bearing reserves at the Federal Reserve into accounts which require no reserves. These programs typically sweep balances out of NOW or demand accounts that have a 10 percent reserve requirement, and into nontransactions accounts, primarily savings accounts, with no reserve requirement. In this Region, banks reported a \$9.0 billion decline in NOWs over the last year, which would reduce noninterest-bearing reserves by \$900 million. It is likely much of the reduction in NOWs in this Region, and nationally, was driven by reserve-avoidance sweeps.

Regional Credit Card Lending

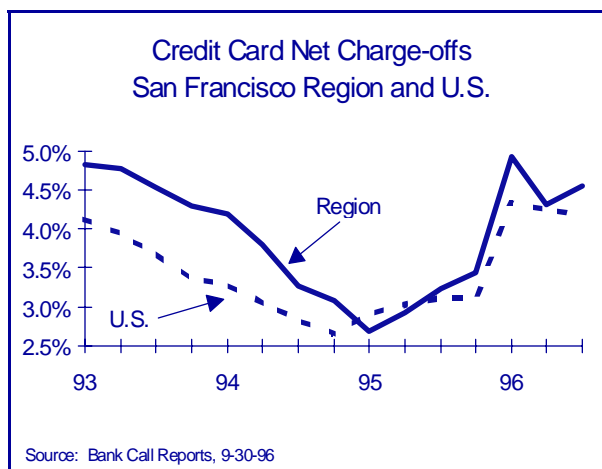
The San Francisco Region's banks (excluding TFR filers) increased credit card lending by \$11.8 billion during the past 12 months, a 31 percent growth rate. However, the relocation of American Express Centurion Bank from Delaware to Utah with its \$8.9 billion credit card portfolio accounts for the majority of the increase. The growth rate adjusted for this one institution actually drops to a more reasonable level of 8 percent. Total credit card loans held by the Region's banks now approximate \$49 billion, with about \$250 billion in credit lines available.



Although credit cards account for only 11 percent of total loans in the Region, credit card charges-offs represent 68 percent of the Region's total charge-offs this quarter, up from 52 percent for the year ended December 31, 1995. On an aggregate basis, the Region's banks registered a high 4.6 percent (annualized) third quarter charge-off rate for such credits, which is up from 3.4 percent for the year ended December 31, 1995 (see Chart 1). Improvement in this trend may not occur in the short-term, as banks in the Region still report past due levels approaching 4.3 percent in this category.

Given the negative performance trends of the Region's consumer loan portfolios and all the recent publicity over consumer debt levels (see **Consumers Declare Bankruptcy in Record Numbers**), the growth in credit card exposure warrants continued close attention by regulators and bank management. In that regard, the OCC issued additional guidance to banks during the third quarter, focusing on maintaining prudent underwriting standards and controls. In addition,

CHART 1



recent surveys have noted that some institutions are raising cutoff scores on their credit scoring models.

Increased attention may be especially important in Arizona, Nevada, and Utah banks, where much of the San Francisco Region's credit card activity is centered. Banks in these states hold over 82 percent of credit card outstandings in the Region. The great bulk of this activity is conducted by affiliates of larger banking and financial services companies. However, exposures are not limited to just one area or larger institutions, as over 600 of the banks in the Region have at least minimal exposure to credit card debt. Fifteen nonmember banks have exposures exceeding 50 percent of Tier 1 capital.

Loan Survey Information

The San Francisco Region's FDIC examiners continue to register concern over commercial real estate loan portfolios and competitive pressures. Surveys conducted by the FDIC Division of Research and Statistics on 130 banks examined in the San Francisco Region during the last six months show:

- Risks associated with commercial real estate loan portfolios were considered "above average" in all four survey categories more frequently than the institutions surveyed nationally. This trend is most evident in the states of Alaska, California, Nevada, and Utah.
- Minimum amortization and large balloon payments were common in 30 percent of the 88 commercial real estate loan portfolios of the surveyed banks in the \$25-\$300 million size category. This condition compares to 23 percent for

all banks surveyed on a region wide basis and 10 percent nationally.

- Funding speculative construction projects was also common in 19 percent of the banks surveyed in the \$25-\$300 million category. Nationwide, this ratio stands at 9 percent for all banks surveyed and 16 percent for the Region as a whole.
- Competitive lending pressures were considered "above average" at about 29 percent of examinations in the Region versus 18 percent on a national basis.
- Higher than normal risk characteristics were found in all three survey categories for the 11 banks surveyed in the Region with total assets less than \$25 million which are active in making business loans.
- Monitoring of collateral positions was considered inadequate in 60 percent of these eleven banks. This compares to 11.2 percent nationwide and 16.0 percent for the region.



struction loans account for over 19 percent of all loans in Nevada banks with under \$1 billion in assets, compared to just over 4 percent for similarly-sized banks nationally.



Commercial real estate lending activity also was strong in several states during the third quarter. *California is finally heating up after several years of negative or nominal growth, despite some lingering asset quality problems, especially in Southern California. The state's 15 percent growth rate for the third quarter was at a level not reached since 1991.* Utah, Montana, Arizona, Alaska, and Washington banks also were active in the commercial real estate lending area with annual growth rates of over 10 percent.

Soft economic conditions in both Alaska and Hawaii contributed to increased commercial real estate delinquency rates during the third quarter. Delinquency in these states now stands at 3.43 percent and 3.27 percent respectively, well above the national average of 1.73 percent.

Construction and Commercial Real Estate Lending On the Upswing

Banks in five states -- Utah, Nevada, Arizona, Montana, and Alaska -- all significantly increased their construction portfolios. Utah led the Region by adding \$298 million or 42 percent to their construction portfolio. *However, Nevada's 37 percent increase may be more noteworthy due to concerns about the state's heavy reliance on the construction sector (see **San Francisco Region Continues to Record Rapid Growth**).* As can be seen from Chart 2, con-

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CHART 2

